



ISSUE 42 SEPTEMBER 2014

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The Small Company Actuary and Risk-Focused Financial Examinations

By Leon L. Langlitz

Remember those fellowship exam questions that always started off: “You are the actuary for a life insurance company ...”? Well, you are that actuary today and you just found out that your company is going to go through its financial examination conducted by the state insurance department. Do you cringe at the thought or welcome the opportunity to show what you do? How can you as the company’s actuary be better prepared to handle the requests, questions and follow-up that will be needed to ensure the examination process concludes successfully? You have also heard from fellow actuaries that your time commitment will be greater and it will be more costly for your company since the insurance department has implemented this new risk-focused examination approach.

In years past you would provide to the examining actuary your workpapers, answer a few questions, and ensure the workpapers reconciled to the reserve amounts in the financial statements. This was when the examination process focused on the company balance sheet and tried to ensure that all the key line entries for assets and liabilities were determined and set correctly. This new examination process is more holistic

in nature. The process is designed to assist the examiner in understanding what the company mission and goals are, what processes are used to achieve those goals, and what risks the company faces that would prevent it from reaching those stated goals. An analysis of those risks is then performed and a determination is made as to whether or not a control or strategy is in place that is effective in mitigating that risk.

Risk-Focused Examination Process

Beginning for all new examinations that started after Jan. 1, 2010, the risk-focused examination approach is becoming more refined and ingrained. However, there seems to be a low rumble—if not a roar—that this new approach is more time-consuming for the actuary and has been more costly to the company. Obviously, that was not the intent when this format was devised. One possible reason for this widespread view is the shift from the old paradigm to this new format has not been applied consistently. If one were to think of this shift along a continuum with the prior balance sheet approach on the left of the continuum and the new risk-focused

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smalltalk

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Chairperson's Corner **ROCKING ON**

By Don Walker

Yes, SmallCo rocks!

It's been a busy first half of 2014 for the Smaller Insurance Company Section (SmallCo) Council and its friends.

First of all—webinars. We love them! Counting the December 2013 year-end prep presentation, we've had three very successful webinars so far in this council year. Working with our partners from the Society of Actuaries (SOA) staff and the Financial Reporting Section, we have been able to provide timely information and continuing education credits to our membership at a very affordable price. This helps our members and it benefits the section by making funds available to support other section activities, especially sponsoring research.

By the time you read this, we will have put on another webinar ("Small Company Strategies for Efficient Product Development" on Aug. 13, in partnership with the Product Development Section). We will have two more webinars in 2014: "PBR Developments Impacting Small Companies" on Oct. 15 and our usual year-end prep webinar "Financial Reporting Issues and Considerations for Year-End" (both presented jointly with the Financial Reporting Section).

That's a good segue into everyone's favorite topic—principle-based reserves (PBR). Your council members have been very active—both in the educational context, through our PBR team headed up by Tim Cardinal, and on the analytical side, providing feedback to groups working on proposed PBR modifications. Short-term emphasis has been on the reserving side; our mid-term goal is to move on to consid-

eration of how the principles-based *approach* will impact smaller companies across a broader spectrum.

Much of this will involve research. Our Research Team, led by section vice chair Pam Hutchins, is on the lookout for worthy research projects that we can sponsor. This is very timely, as the SOA is ramping up its overall research efforts and looking to the sections for potential research topics, participation in project oversight groups (POGs), and shared funding.

Productive research can provide topics for webinars; it can also lead to meeting sessions at the big SOA gatherings. SmallCo is a very active participant at the Life & Annuity Symposium, the Valuation Actuary Symposium, and the annual meeting. We try to offer sessions that present the current hot topics with the SmallCo spin—how do you cope with this challenge with limited resources? And we continue to sponsor our extremely popular buzz groups and forums.

Those are big items that get a lot of exposure. We also do a lot of work as a council via our monthly calls.

We keep our eyes on current activities of the National Association of Insurance Commissioners' (NAIC's) Life Actuarial Task Force (LATF) and other regulatory bodies. We have council members and friends who monitor LATF calls and meetings. They circulate their impressions via our council email "listserv" and will call in if they have something that requires discussion. If the council sees or

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hears something that we think you'd especially like to know about, we can send a BLAST EMAIL to our section members. If it's not QUITE that important, we can post it to our section Web page on the SOA website. (We respect that you don't want to be bombarded with emails about every little thing.)

We continually try to strike the appropriate balance between education and advocacy. As a section of the SOA, we will primarily lean toward education. But in order to be able to educate, we will sometimes need to present the views of advocates. The important distinction is that we will not favor one point of view over another.



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It's an exciting time to be an actuary, and it has been a stressful time to be a smaller company actuary. But hopefully, through the efforts of your section council and "friends," SmallCo has helped you stay abreast.

And you can get involved too! We welcome guests on our monthly one-hour calls (generally the third Thursday from 2:00 to 3:00 Central; contact Christy Cook at the SOA for details). Dip your toe in the water! You might hear a topic that interests you! And maybe you can give another hour or two to participating in an email discussion or a committee call. Your idea could be a key contribution to solving a problem.

Enjoy this issue of *Small Talk*. And keep rocking! ●



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approach on the right, what is apparent is that each state insurance department is at a different point along that continuum in trying to implement the new approach. Even examiners-in-charge (EICs) for the same state could be placed along this continuum at different points. Just like all change that affects people, some can accept totally and jump in with both feet while others are more moderate and methodical in their approach to accepting of the change. They may take longer to embrace the changes that the new process requires.

For those who may be unfamiliar with the NAIC risk-focused examination approach, a brief synopsis is provided. For additional background on the risk-focused examination process, I would refer the reader to an article, “The Risk-Focused Examination,” written by Frank Clapper in the June 2014 issue of *The Financial Reporter*. Frank discusses the background of the risk-focused examination process and provides detail on the various phases of the process.

There are seven phases of this approach, which can be summarized as follows:

- Phase 1** Understanding the Company and Identifying Key Functional Activities
- Phase 2** Identify and Assess the Inherent Risk Found in the Activities
- Phase 3** Identify and Evaluate the Risk Mitigation Strategies or Controls
- Phase 4** Determine Residual Risk
- Phase 5** Conduct Detail Examination Procedures
- Phase 6** Update Prioritization and Supervisory Plan
- Phase 7** Draft Examination Report and Management Letter

The actuary is primarily going to be involved in Phases 1, 3, 5 and 7. The amount of time and effort needed by the actuary will vary for each phase.

Phase 1

In Phase 1 the examination team is working to understand the company, determine what the material risks the company may be facing are, and how the governance structure of the company works to mitigate those risks. A key element of this process is the interview. The senior officers are all interviewed, and that includes the chief actuary and generally the appointed actuary if that is a different individual. This may be the first encounter the actuary has with the examination process.

Actuarial Interview

There are a number of key areas that are targeted during the actuarial interview. Some areas may be emphasized more than others given the circumstances, but generally these are the areas the actuary should think about when notified of the interview.

Background and Experience

The interview begins with the actuary discussing his or her background and experience. This information is important if the actuary is new to the position. The actuary’s information found in the SOA directory may be checked to determine whether the actuary is compliant to sign the actuarial opinion. Documentation of the continuing education that gives rise to the compliant status may be requested. A copy of the letter naming the actuary as the appointed actuary that is sent to the insurance commissioner may also be requested.

Operations

The actuary would then be asked about the organization: Who reports to the actuary? To whom does the actuary report? What kind of experience does the actuarial staff have? How long has the staff been in place? How often and what kind of interaction takes place? These are some of the items that may be explored. The examiners will want to know how much contact the actuary may have with senior management and/or the board of directors.

Reserves

The reserving process is then probed. What are the procedures used to set the reserves? What systems are used (have they changed since the last exam)? What steps does the appointed actuary take to get comfortable with the reserves, especially if they are actually generated by someone else? These are just a few of the types of questions one may get. Generally, the questions regarding reserves are more about the processes that are in place to ensure they are properly being computed. This is especially key for those reserves that allow the actuary to use some judgment in determining the amount. For example, in determining unpaid health liabilities, questions as to what influence does senior management have on the level of reserves may be explored.

Pricing and Underwriting

While the actuary may have been accustomed to responding solely about valuation issues, the risks of pricing and underwriting have become more significant and are usually explored. What kinds of risk these areas pose for the appointed actuary and how the actuary works to understand and if necessary mitigate those risks is the key element of this line of questioning.

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ERM and ORSA

A line of questioning regarding enterprise risk management (ERM) and Own Risk and Solvency Assessment (ORSA) (if subject to) is also discussed, trying to determine at least from the actuary's point of view the material and relevant risks the company is facing and what the response is to deal with those risks.

Reinsurance

The reinsurance program is also explored, including how it is used to mitigate risk.

Ethics

Finally, ethics is an area that is explored—personal ethics and corporate ethics. Questions that are generally asked include: What kinds of ethics training are used by the company? Does the actuary know of any instances of fraud against the company?

The actuary may be requested to provide follow-up documentation of anything significant that comes out of the interview. Also, depending upon the organizational structure, other actuaries may be interviewed, i.e., pricing or modeling actuaries if it is determined they can shed light on the company. The results of the interviews are summarized, and the summaries become a part of the examination record.

Phase 2

Once all of the interviews have been completed and summaries created, along with the other planning that has been performed, the process moves to Phase 2. Key risks have now been identified, and in this phase those risks are assessed. This is completed by the examining staff. Risks are evaluated using a metric where magnitude of impact on surplus versus likelihood of occurrence is measured with resulting risks being labeled as high, moderate or low. A risk with significant impact on surplus with high frequency of occurrence would probably dictate a high level of inherent risk.

Phase 3

In this phase the identification and evaluation of the risk mitigation strategies or controls occur. This is the next phase where the company actuary will be asked to provide information or answer additional questions. In this phase the examiner is not looking at the ending reserve numbers that are posted to the financial statement that is under examination. Rather, the examiner is trying to determine whether the company has in place the types of controls that will assure the examiner whether those risks that could have a significant impact on a company's surplus do in fact have a very low chance of occurring.

Risk Matrices

The risk matrix is essentially a score or tally sheet. The prior information gathered in Phase 1 and the risks assessed in Phase 2 are used to develop a risk matrix. This document outlines the risks that have been identified and whether they result in a high, moderate or low risk category. Obviously, those risks identified as high require the most time to review. The Phase 3 step is to review company controls that have been set up to mitigate the identified risk. Once the controls have been identified then the question is whether the controls have been designed appropriately to mitigate the risk. Some of the matrices developed where the actuary may be called upon to provide information include those for the reserving risk, pricing risk, underwriting risk, premiums, investments and claims. Generally, the risk matrix is created in an Excel spreadsheet. Risks are listed down the sheet while the different phases are shown across the top. Risks are identified in the Phase 1 column; the Phase 2 column will show the determination of whether the identified risk is in the low, moderate or high categories. Phase 3 generally takes two columns: The first column describes the control strategy that has been identified to mitigate that particular risk. The second Phase 3 column is completed when the control is evaluated. The results of the testing are shown. There are identifying codes that direct the examiner to the location of the documents that have been used to support their conclusions.

SOX & MAR Controls

If a company is subject to the Sarbanes-Oxley Act of 2002 (SOX) or the Model Audit Rule (MAR—NAIC Model Regulation #205), there should be substantial documentation of the controls that have been designed for each identified risk. If that is the case, the examiner will want to review the documentation supporting the implementation of that control, i.e., a sign-off document by the appropriate individual. The evaluation also consists of a qualitative aspect to try to determine whether the identified control really does reduce the risk from occurring. If a company is not subject to either the SOX or MAR regulations, the effort necessary for the examiner increases substantially. This could significantly impact the amount of time the actuary will need to devote to the examination process. The actuary will be asked to document the reserving process and steps the actuary goes through to ensure the calculated reserve amounts are appropriate, for example.

Outside Auditors

Information from a company's outside auditors is used. If the auditors have completed detailed testing of a reserve or reserve process and the examiners believe the testing was sufficient and reliable for their purposes, they will rely on

that information and waive additional control testing. Or they may supplement the testing with additional tests of their own.

Example

As an example, a key risk for health insurers is the determination of incurred but not reported (IBNR) reserves. The impact of setting wrong reserves can be significant on surplus, and there is a high frequency of occurrence of wrong reserves being calculated especially when setting reserves every month. So what does Phase 3 testing look like? First, as part of the Phase 1 discussions you know the company uses lag triangles to set determine reserves. There is a reconciliation performed of the data in the triangles to that data that goes into the general ledger. Next, once the reserve estimate has been determined, there might be a meeting of the senior management, claims and pricing/UW personnel to discuss the level or change in the level of reserves. Once everyone agrees to the amount, the reserves are posted to the financial statement. The controls on this risk of misstatement of reserves have several pieces. First there is the reconciliation of lag data to the general ledger; second there is a meeting to discuss the level of reserves; and finally there is sign-off that management agrees with the amounts determined. So the Phase 3 analysis will look to find the reconciliation and the documentation that supports it. Next, since there is to be a meeting, the examiners will check to make sure the meeting actually took place, look for meeting notices and who received the notices, and get that documentation. Finally, if there is a sign-off by management as to the reserves, that documentation will also be added into the examination work record. There should be a document with signatures that support that control that is the document that goes into the examination file.

Documentation

In short, the key word for the Phase 3 testing is documentation. Good documentation of the processes and procedures you use when setting reserves, pricing or paying claims is more important than ever. Good documentation may allow the examiner to pass on a lot of the Phase 5 testing discussed below.

If you are the appointed actuary for a company not subject to SOX or MAR, you should develop documentation that describes the approach and process used to develop the IBNR or any reserve that may have a significant impact on surplus if not determined correctly. The testing in this phase did not check whether the amounts were calculated correctly but rather were the established processes used to ensure the appropriate determination of reserves followed and are those processes applicable to that, ensuring the risk is mitigated.

Critical Risk Areas

When the NAIC began this risk-focused approach, potential risks were identified and placed in a database the examiners could access and use in their work. These risks were such that almost all companies would be subject to them. It was pretty much a given that these were the risks that needed to be reviewed—in certain instances, no more and no less, even if they were not necessarily applicable to the company. That thinking has evolved as people have become more familiar with this process.

Good documentation of the processes and procedures you use when setting reserves, pricing or paying claims is more important than ever.

The NAIC is now producing what are described as critical risk areas, things like credit, market, pricing/underwriting, liquidity, operational, reserving, legal and a few others. The examiner is to determine the specific risks a company may be exposed to that are in these broad categories rather than rely on specific risks populated in the database. It will be an evolutionary process as to how quickly the critical risk areas will be incorporated into the examination process. As examiners become more confident in identifying the risks that are specific to the particular company, the reliance on predetermined risks will subside.

Phase 4

In this phase the examiner reviews the information and documentation obtained in Phase 3 and then makes a determination as to the amount of residual risk that still remains of the original defined risk, i.e., how well did the controls reviewed actually mitigate the risk. Again a table is used to quantify this residual risk. Beginning with the

Phase 2 inherent risk assessment of high, moderate and low, cross-referenced with how well the controls mitigated the risk, provides the amount of residual risk that remains. This residual risk is measured on high, moderate or low basis. Once each of the risks has been analyzed, the process moves to Phase 5.


Phase 5

From an actuarial standpoint at least, this is the phase where the traditional actuarial examination testing would be performed. If the residual risk is rated high, substantive detail testing would be performed. As an example, if the determination of life reserves was indicated as having a high inherent risk, the misstatement of the reserves could have a material effect on the level of surplus. Controls were reviewed and determined that for the most part they were sufficient, appropriate, and being applied correctly. However, the company embarked on marketing a new line of business since the last examination. While the control assessment may have been strong for the existing business, for this new business there may have been moderate or low control assessment. This scenario would require what can be deemed traditional examination testing of reserves. A request to receive the seriatim in-force listings and actuarial statements of basis as the components to begin review would be made, then a recalculation of the reserves for a sample of contracts to assure the examiners that the calculations were correct. This testing constitutes the substantive or detail testing. In theory, if the controls are strong this should greatly reduce the amount of detail testing that needs to be completed.

Theoretically, the type of testing being done at the Phase 5 level should be less than what has traditionally been done under the prior examination approach. There are states that just require the examining actuaries to assist in the examination, complete the assessment of the actuarial controls, and do any detail testing as may be required as a result of the control assessment. The examining actuaries then summarize their work and complete their assignment. Other states, however, because of how their laws and/or regulations are written, require the examining actuaries to provide an Actuarial Opinion on the level of reserves shown in the financial statement as of the examination date (year-end).

In this case, despite what the risk matrix may say is necessary for work that needs to be completed in Phase 5, the actuaries still need to comply with the appropriate ASOPs and do enough testing, calculations, etc. that they can provide a signed actuarial opinion. Thus, in those states, more detailed testing will probably be required than might be necessary otherwise.

The NAIC and the state insurance departments are endeavoring to work more closely together and get many of a company's affiliates to be examined at the same time. In many instances this involves coordinating with more than one insurance department. These multistate coordinated exams also can mean more testing is performed than what might actually be required if strictly following the risk matrix. Generally, what happens in these multistate coordinated exams is that a lead state is designated, primarily because the main or most important company is domiciled in that particular state. That state then begins the examination process and moves through the various phases as has been discussed. It may be entirely probable the controls and processes used at the main company are the same as those used by many or all of the other affiliated companies. The risk-focused process is to recognize this and hopefully shorten or abbreviate the need to re-perform the procedures on all the affiliated companies. However, state law may dictate the examiners and the examining actuary to conduct additional testing on the particular affiliate because it cannot rely on the testing solely performed by the lead state on the main company. This is especially true if business from that particular state was not included in the testing conducted by the lead state examination team. Thus, even though the process as designed is an attempt to streamline and make the process more efficient, there are instances where current state law or regulation may not allow that to happen to the fullest extent.



A company with a strong ERM plan should find the examination process simply an evaluation of that work.

Phase 6

Once all of the detail testing has been completed, the examiners will use all of the information that has been developed and update the company's priority and/or supervisory plan. At least once a year the domestic state insurance department updates its supervisory plan for each domestic insurer. This

plan is based on information the state gathers from the quarterly financial analysis that it does and then supplements that information with the results of the examination. The plan should be concise and outline the type of surveillance planned, the resources dedicated to the oversight and coordination with other states. For a well-managed, well-capitalized company, the plan will not be extensive.

Phase 7

The last phase encompasses the final completion of the examination report and management letter. For the company actuary this will be where any recommendations that are made will be found. The actuary should review these items and can either implement the recommendations or may find that the recommendation may be impossible or impractical to implement. If the latter, the actuary should provide clear, sound documentation and provide that to the examiner or the in-company contact so that when the examination reoccurs in the next three to five years and the examining actuary is reviewing the prior recommendations to see whether they have been implemented or not, reasons for not following up will be readily available and the issues can be dealt with early rather than later in the examination process.

One may be able to think of this risk-focused examination process as an extension of a company's ERM process. A company with a strong ERM plan should find the examination process simply an evaluation of that work. A company with strong ERM will have identified its risks, will have developed strategies to manage the risks, will have documented what those strategies are, and will be able to show that the processes are working. These companies should find the examination process to be a verification of all of that ERM work that should be beneficial to all concerned.

In summary, while this whole risk-focused approach may seem to be time-consuming and expensive, the intent is that with experience, the process can be streamlined and made more relevant and efficient. It is certainly not a perfect process and there is room for improvement. The company actuary is a key component for ensuring a successful completion of the examination process. If the reserving process is well-documented, if the controls that have been devised are designed well, and if those controls are effective in ensuring the risk is minimized, then the amount of time the actuary is needed to work with the examination team can be minimized. ●

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Coming Events

By Tim Cardinal, Narayan Shankar and Don Walker

Annual Meeting

The Smaller Insurance Company Section (SmallCo) will be sponsoring three sessions at the 2014 Society of Actuaries (SOA) Annual Meeting. SmallCo events kick off with a hot breakfast at 7:15 a.m. on Tuesday, Oct. 28, where attendees can network and enjoy breakfast in a casual atmosphere. Section leaders will provide a brief update on section activities, and attendees will have an opportunity to propose initiatives for the section to focus on in the upcoming year. Attendees will divide into small groups for a Competency Framework Workshop: Differentiate and Integrate Yourself—Develop your competencies with the SOA Competency Framework.

Later the same day, at 2:00 p.m., there is a buzz group session titled “Current Topics Impacting the Smaller Insurance Company.” Smaller company actuaries attending the buzz group will share stories from the first half of the year and ideas for the remainder of 2014 and beyond. Discussion will range from the impact of the economic environment to the state of regulation as well as the professional challenge of fulfilling numerous responsibilities with limited resources. Connect with peers who have walked in your shoes and build a network of associates who have similar issues and experiences, to learn from and share ideas with now and in the future.

On Wednesday, Oct. 29, SmallCo is offering an innovative session titled “Life Insurance Illustrations—A Reality

Show.” Join the panel and watch as a reality show unfolds. The panelists will conduct a series of mock quarterly meetings between Product Development, Risk Management, Information Technology (IT) and Marketing/Corporate Management departments as they collaborate to support a company’s life insurance illustration requirements. The panelists will role play issues surrounding illustrations including regulatory compliance, illustration software testing, user needs, risk management, and new product and in-force support as challenges, deadlines, resource constraints, professionalism, industry practices and conflicting priorities are all thrown into the mix. These sessions, focused uniquely on the issues of smaller insurance companies, are intended to enrich your learning experience at the annual meeting in a way that will be directly relevant to your daily challenges as a smaller company actuary.

Oct. 15, 2014 Webinar—PBR: Help Wanted!

As principle-based reserving (PBR) looms on the horizon, two things seem certain—models will be needed and documentation will be required. The webinar’s two main topics are:

- 1) For a company with simple products taking the “minimal” path—what is the minimum documentation—for yourself, management/board, regulator, auditor, rating agency?
- 2) How to use asset adequacy models for both asset adequacy and exclusion tests and PBR.

We will also cover a hodgepodge of updates—proposals and changes, and the latest status on adoption by the states.

PBR Corner

In the meantime, check out the PBR Corner on the SmallCo website:

<https://www.soa.org/Professional-Interests/Smaller-Insurance-Company/pbr-corner.aspx>

Corner resources include:

- Sample stochastic exclusion ratio test calculation
- VM-20 adoption status
- Valuation Manual with non-substantive revisions through March 31, 2014
- Term net premium reserve (NPR) calculation
- PBA Implementation Guide.

The Corner will add new resources on documentation and models by early fall.

Year-End Webinar: Financial Reporting Issues and Considerations for Year-End 2014

Be on the lookout for our annual year-end webinar! If you are the Appointed Actuary for a small company (or a big company), or if you want to simply stay up-to-date on the latest issues for year-end 2014 financial reporting, this webinar is for you.

Every year since 2009, SmallCo partners with the Financial Reporting Section to bring you a webinar covering the important issues for the current year-end. We keep you abreast of current practice, covering such issues as Special Considerations Letters from the various states, interest rates, scenarios and particular challenges we think you will encounter. Whether your taste is STAT or GAAP, we'll tell you what's hot this year.

And you get continuing education credit! What could be better?

And one more thing—Now is the perfect time for you to let us know the topics that YOU would like to see us cover. Drop SmallCo's section specialist, Christy Cook, an email at ccook@soa.org and tell us what's on your mind. (Make sure to identify it as pertaining to the YEAR-END WEBINAR.)

SMALLCO ROCKS! ●

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SOA 2014

SOCIETY OF ACTUARIES
Annual Meeting & Exhibit

Oct. 26-29, 2014
Rosen Shingle Creek
Orlando

Invent
Change
Adapt
Learn
Build
Innovate
Perform



Through the profession,
collaboration, research, education and
our members...

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25+ PRODUCTIVE
NETWORKING
OPPORTUNITIES

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300+ DEDICATED
PRESENTERS

Opportunities for Small Life Insurance Companies to Improve Asset Yields

By Mark Whitford

Executive Summary

Insurance companies are under intense pressure to maintain profitability in the face of increasing competition, low interest rates, increased regulations (Own Risk and Solvency Assessment (ORSA)), and the risk of high inflation. The liability duration of most insurers tends to be over 10 years, with some having liability duration over 30 years (long-term care). As companies look to make an interest rate spread off of the discount rate used in pricing, investment income plays a vital role in the profitability of insurers. In today's low-interest-rate environment, generating that necessary investment income has often resulted in companies having to increase their exposure to investment risk.

The goal of this article is to share ideas with small life insurance companies on how they can seek to increase their asset yield.

With bond yields lower than they have been historically, opportunities to invest for yield have diminished. If this trend continues, investment income levels could decline further unless risk tolerance levels are re-evaluated and the credit quality of investment portfolios is adjusted accordingly. High-yield corporate bonds, bank loans, securitized mortgages or income-producing equity securities may represent an attractive option for improving current income while remaining within a targeted risk spectrum.

As companies increasingly rely on income from investments to meet the challenges ahead, we suggest that the need for proper evaluation of the composition and risk level of their investment portfolios is becoming more urgent.

Risk-Based Capital (RBC)

First we begin our analysis of RBC. The importance of RBC ratios is twofold:

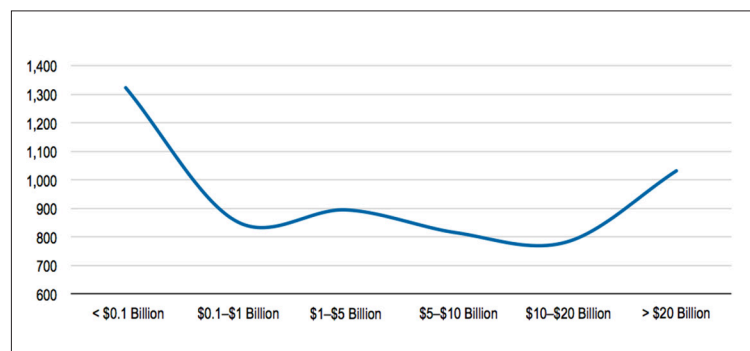
- Insurance companies must maintain a minimum amount of capital on the balance sheet to remain in business and avoid increased regulatory scrutiny.
- Comparing RBC ratios across a competitive set provides a measure of risk tolerance, particularly when evaluating a company relative to other insurers of similar size and type.

I suggest ample room exists to potentially increase investment income levels by selectively adding risk to investment portfolios.

As shown in Figure 1, RBC ratios as defined by invested asset base vary by company size and tend to drop as a company grows, except for the largest companies. There may be room for some small companies to take the RBC hit of going further out on the credit curve, resulting in increasing asset yields.

Figure 1: RBC Ratios According to Company Size

As of Dec. 31, 2013

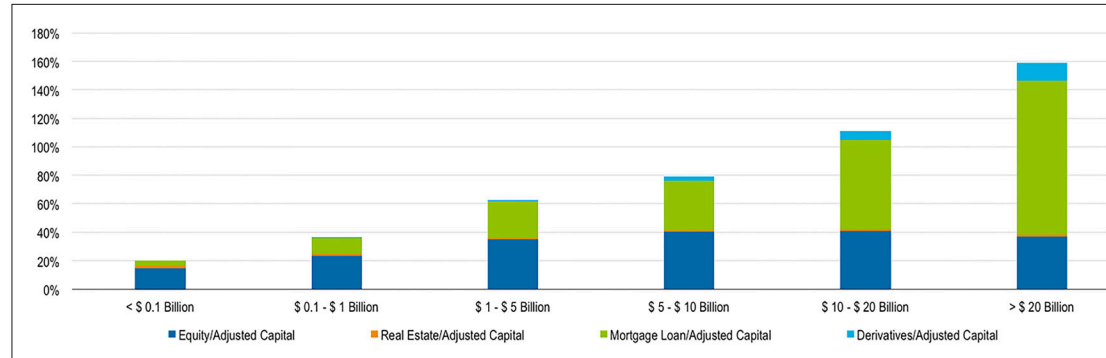


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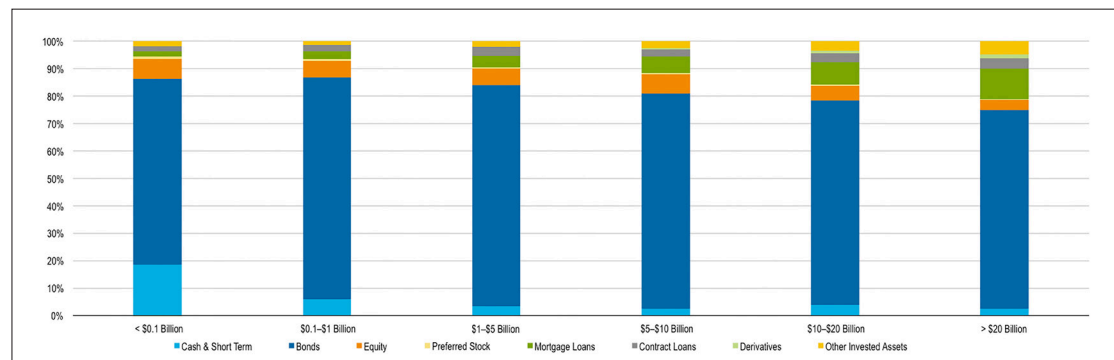
Figure 2: Proportion of Risk Assets as a Percentage of Capital and Surplus of L&A Insurers by Size
As of Dec. 31, 2013

As companies grow in size, they tend to increase allocations to riskier asset classes, appearing to demonstrate a preference for equity investments.



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Figure 3: Asset Allocation Profiles of L&A Insurers by Size
As of Dec. 31, 2013



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Asset Risk Analysis: Credit Risk

Credit risk can have a major impact on total investment returns for insurers, as was demonstrated in 2008 at the height of the global financial crisis.

I categorize risky asset classes as high-yield bonds, preferred and common stock, schedule BA assets and “other invested” assets. Figure 2 compares the percentage of surplus that insurers invest in these riskier asset classes. Here again there may be room for some small companies to increase investment yield by taking on more risky assets.

Asset Risk Analysis: Investment Risk Comparison

Insurance companies tend to hold less cash and maintain larger allocations to mortgage loans, contract loans and “other invested assets.” As the invested asset base increases, there tends to be a corresponding increase in allocations to riskier asset classes and a decrease in investment in cash and bonds.

In addition to evaluation of liquidity and credit risks, a review of investment portfolio composition also reveals several interesting themes. Figures 3 and 4 compare the asset allocation decisions of insurance companies by size.

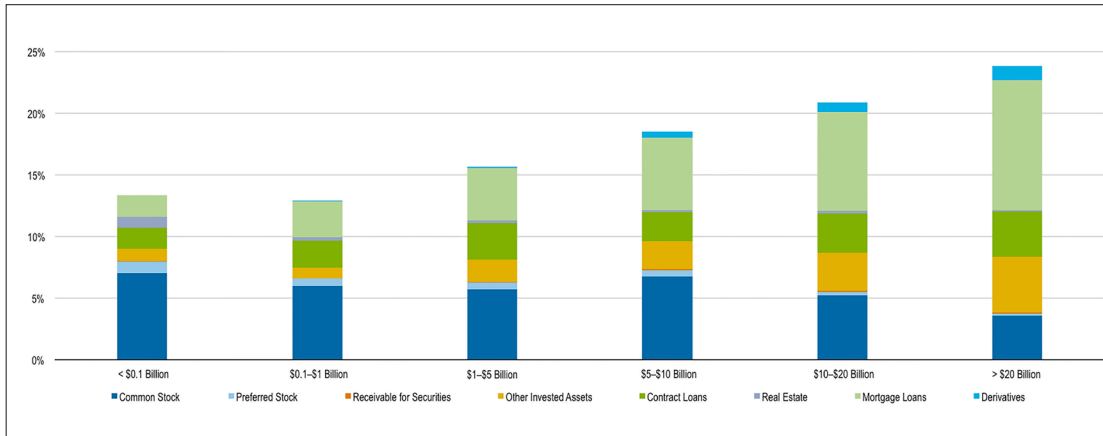
Asset Risk Analysis: Bond Allocations

Examination of bond portfolios in isolation provides further evidence of the relationship between risk tolerance and invested asset base (Figure 5). As the invested asset base increases, the allocation to National Association of Insurance Commissioners (NAIC) 1-rated bonds (AAA–A) declines, while the allocation to NAIC 2 (BBB) and NAIC 3-6 (high-yield) bonds rises.

Asset Risk Analysis: Maturity Allocations

Examination of bond maturity also provides further evidence of the relationship between risk tolerance and invested asset base (Figure 6). As the invested asset base increases, the allocation to longer-maturing assets increases. I can see a decrease in allocation to maturities less than five years and an increase in the 10-plus maturity bucket.

Figure 4: Asset Allocation Profiles of L&A Insurers (Excluding Cash and Bonds)

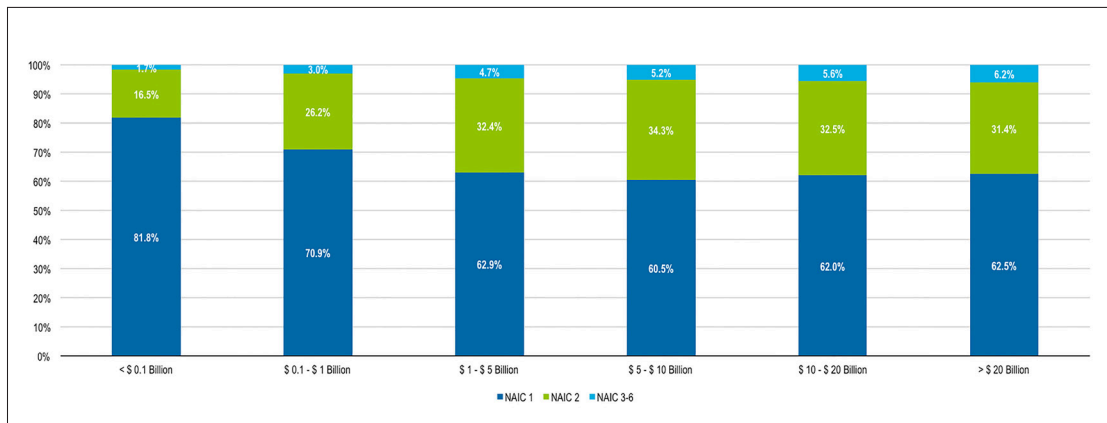


Larger companies appear to have a greater tolerance for holding more illiquid assets.

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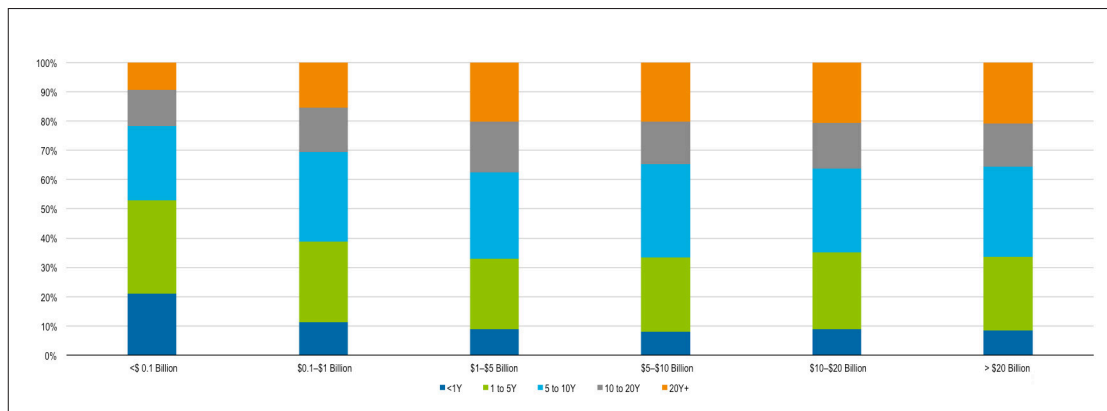
Figure 5: Distribution of Holdings by Bond Ratings for L&A Insurers by Size

As of Dec. 31, 2013



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Figure 6: Maturity as % of Bond Portfolio



As the invested asset base increases, the average portfolio maturity tends to increase.

Continued on page 16

In Search of Yield

Recent capital market trends may drive further changes in asset allocation decisions and risk tolerance levels. With the exception of the 2008 crisis period, overall bond yields have declined meaningfully over the last decade, and opportunities to invest for yield have diminished. Looking at Figure 7, we can see smaller companies' net yield has been impacted more by the low-interest-rate environment than larger companies' has. Prior to 2008, an AAA-rated security yielded approximately 4 percent; today, that same security would yield closer to 2 percent. If this trend persists, we believe investment income levels could continue to decline unless risk tolerance levels are re-evaluated and the credit quality of investment portfolios adjusted accordingly.

Insurance companies seeking to boost investment income in an environment of diminishing yields may benefit from a shift in asset allocation to potentially higher-yielding opportunities, such as high-yield corporate and municipal bonds, bank loans, select opportunities within mortgage-backed securities (MBS) or income-producing equity securities. Such assets may produce yields ranging from 3.5 percent to over 7 percent, though they bring with them a higher risk profile. One other area that has been gaining traction lately is NAIC-rated funds. As small companies may have trouble investing in certain asset classes, on a separate account basis, funds make sense since they can invest a smaller amount and still get the diversification as a larger allocation. Rated funds help change the rating from a high equity factor to a lower factor (NAIC 1-4). As we move forward, our expectation is to see an increase in the number of rated funds. We believe the higher-yielding asset classes we have discussed may represent an attractive option for improving current income while remaining within a targeted risk spectrum and providing additional potential diversification benefits. To learn more about rated funds, feel free to contact me or ask your current investment manager for a list of rated funds.

Conclusion

Insurance companies have accumulated huge amounts of assets. Those assets are mainly invested to match the obligations to millions of policyholders. The investment performance of those assets not only contributes to an insurer's profitability, but also to its competitiveness and growth of capital.

Against this backdrop of increasing pressure on margins spurred by growing competition and regulatory changes,

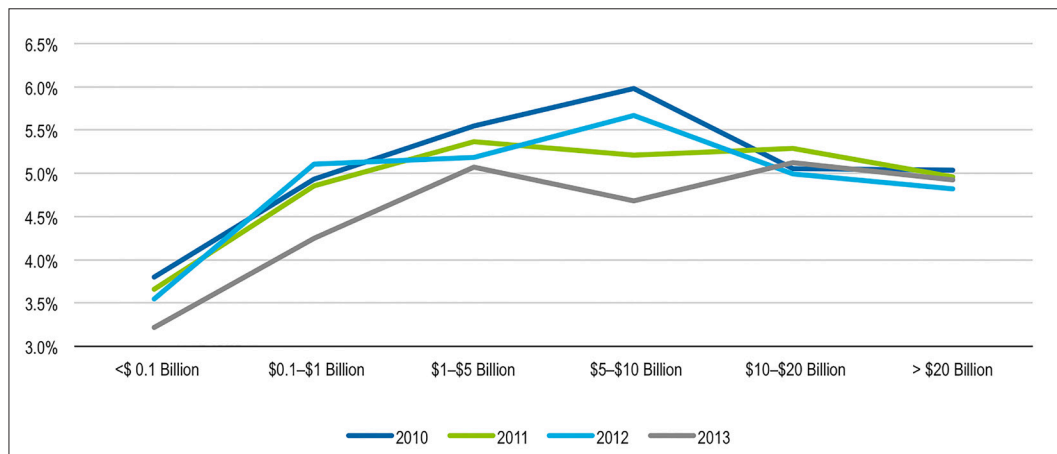
insurance companies face the challenging task of improving margins while maintaining appropriate liability coverage and capital ratios.

As companies rely more on income from investments, we expect the need for proper evaluation of the composition and risk level of investment portfolios to become more urgent. Our analysis has led us to believe there is an opportunity to increase profitability by selectively adding risk to an insurer's investment portfolio. The process of balancing the drivers of both assets and liabilities can be challenging.

A WORD ABOUT RISKS

High-yield debt securities (including loans) and unrated securities of similar credit quality ("high-yield debt instruments" or "junk bonds") involve greater risk of a complete loss of an investment, or delays of interest and principal payments, than higher-quality debt securities. Issuers of high-yield debt instruments are not as strong financially as those issuing securities of higher credit quality. High-yield debt instruments are generally considered predominantly speculative by the applicable rating agencies as these issuers are more likely to encounter financial difficulties and are more vulnerable to changes in the relevant economy, such as a recession or a sustained period of rising interest rates, that could affect their ability to make interest and principal payments when due. If an issuer stops making interest and/or principal payments, payments on the securities may never resume. These instruments may be worthless and an investor could lose its entire investment. The prices of high-yield debt instruments fluctuate more than higher-quality securities. Prices are especially sensitive to developments affecting the issuer's business or operations and to changes in the ratings assigned by rating agencies. In addition, the entire high-yield debt market can experience sudden and sharp price swings due to changes in economic conditions, stock market activity, large sustained sales by major investors, a high-profile default, or other factors. Prices of corporate high-yield debt instruments often are closely linked with the company's stock prices and typically rise and fall in response to factors that affect stock prices. High-yield debt instruments are generally less liquid than higher-quality securities. Many of these securities are not registered for sale under the federal securities laws and/or do not trade frequently. When they do trade, their prices may be significantly higher or lower than expected. At times, it may be difficult to sell these securities promptly at an acceptable price, which may limit an investor's ability to sell securities in response to specific economic events or to meet redemption requests. As a result, high-yield debt

Figure 7 : Net Portfolio Yield for L&A insurers by Company Size



Larger companies' net yield has not been impacted as much from the low-interest-rate environment as smaller companies' has.

instruments generally pose greater illiquidity and valuation risks. Substantial declines in the prices of high-yield debt instruments can dramatically increase the yield of such bonds or loans. The decline in market prices generally reflects an expectation that the issuer(s) may be at greater risk of defaulting on the obligation to pay interest and principal when due. Therefore, substantial increases in yield may reflect a greater risk by an investor of losing some or part of its investment rather than any increase in income from the higher yield that the debt security or loan may pay to an investor on the investment. ●

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Regulatory Update, First Six Months, 2014

By Norman E. Hill

This material is prepared as of June 22, 2014. Since events in the insurance industry remain volatile and dynamic, readers are strongly encouraged to read email blasts from the Society of Actuaries, its Smaller Insurance Company Section Council and other industry publications up to the date of *Small Talk* publication.

Opinions expressed in this article are solely those of the author, and not necessarily those of *Small Talk* or the Society of Actuaries.

Unclaimed Property

This topic is now sufficiently important to be covered in a separate working group under the A Committee. The issue is insurer use of the Death Master File (DMF) of the Social Security Administration. Since some companies used the file to check whether annuity recipients were still alive, state treasurers, attorneys general and other officials started to audit insurers for compliance of their life in-force with up-to-date benefit payments. For deceased policies with no available beneficiary, state escheat laws have been invoked for governments to take over proceeds.

Several of the largest life insurers have already been audited and have turned over substantial amounts to states. The American Council of Life Insurers (ACLI) has drafted a model bill that corresponds to terms of several of these settlements:

1. Ongoing matching of DMF against all in-force.
2. “Fuzzy” matching—that is, if almost all of policy numbers or names match, further investigation is required; inability to make final resolution is decided in favor of a match.

At the last National Association of Insurance Commissioners (NAIC) meeting, representatives from two trade associations objected to this approach. They want DMF matching only of new issues since the beginning date. Also, they want only exact matches to require payment. Finally, they demand

better coordination of regulator efforts between insurance departments, state treasurers and attorneys general.

Captives and Principle-Based Reserves (PBR)

Today, 30 states allow captive insurers to be formed. Most new enabling legislation has been to allow reinsurance to captives on preferred term and universal life with secondary guarantees (ULSG). Key issues for captives are now under auspices of the PBR Implementation Task Force (ITF), with charges to be made to the Life Actuarial Task Force (LATF). Rector, a consulting firm, issued a report on captives in February 2014, and a Modified Recommendation report as of June 4, 2014.

With PBR legislation still pending, several writers of preferred term and ULSG have employed captives to obtain relief from perceived redundant statutory reserve requirements. Further, ACLI representatives have testified that these companies obtain 15 percent more reserve relief than available under the current version of PBR in VM20 of the new law/regulation package. In my opinion, their implication is that these writers will continue to use captives in some way, even after PBR final adoption.

Rector’s first report concluded that the need for captives for these two products would disappear once PBR was adopted. But the above testimony during the March 2014 NAIC meeting strongly indicated otherwise. Rector emphasized that its main objective is achieving reserve uniformity among companies.

Rector’s modified report implies that the reason for 15 percent extra reserve relief to writers is use of PBR VM20 methodology without the net premium reserve (NPR) floor. Previous indications from the NAIC’s PBR Impact Study were that reserve floors served to increase PBR reserves noticeably. Of course, other modifications are also possible to obtain the 15 percent.

Rector seems to state that if NPR floor removal is allowed for these plans, some modification to PBR legislation will be required. However, as described below, this can be disputed.

A related proposal for captives to help achieve desired reserve relief is to allow use of letters of credit (LOCs) as admitted captive assets. Instead of just a bank promise to provide reserve security, part of the LOC would actually be included in the asset base, turned over to the captive by the ceding parent. My interpretation of the amount of LOC asset and workings of Rector's Actuarial Method is:

1. Reserves actually held by the captive = formulaic or current PBR, once the latter is adopted, with no change to methodology; less
2. Reserves calculated under a modification of PBR and VM20, which Rector's report calls the "Actuarial Method." Possibly, these reserves would be modified by removal of the NPR floor requirement, updated by the newest CSO2014 or other mortality, or other devices. With removal of this floor, the ACLI recommends straight use of deterministic reserves (GPV) for preferred term and stochastic reserves (SR), (or the greater of SR or GPV) for ULSG. Again, for this purpose, the Deterministic Exclusion Test (DET) would be eliminated, even while GPV and SR would correspond to full VM20 methodology.
3. Tests of the reserve method in #2's Actuarial Method would be required to see if the resulting asset allocation, LOC versus conventional, provides desired reserve relief. In #1, reserve comparisons under both formulaic and current PBR might be required.

In other words, the Actuarial Method is an internal method, aimed only at these two products. Assets allocated to these products other than the LOC would be conventional NAIC admitted assets. No change to reserve methodology in #1 would be called for. The Actuarial Method would use VM20 methodology, but not replace it. The method would not affect reserves actually held, NPR actually held, or effect on federal income taxes.

In the meantime, LATF will be committed to at least several calls to discuss captives and the June 4, 2014 Rector report. They would try to reach consensus on developing this Actuarial Method.

Some have complained about the amount of time and effort devoted to these two products outside of PBR. The original intent of PBR was primarily to provide reserve relief through VM20, not through alternative devices.

Small Company Exemption (SCE) and Oklahoma

In December, the ACLI promised that it would soon provide a proposed amendment that would exempt small companies from PBR reserve calculations (although not mandatory data collection). At the March meeting, it fulfilled this promise. The premium threshold for exemption would be \$300 million, and \$600 million for a group. RBC ratios would have to be at least 450 percent, and a clean actuarial opinion would be required.

Although the amendment was adopted for a 45-day exposure period, no action at all by LATF has been taken since March. The American Academy of Actuaries stated that it could only support exemptions based on product risk, not company size. At least three LATF members have voiced opposition to the amendment. Although there are emphatic differences of opinion, an increasing number of observers believe that its final adoption by LATF is in doubt. If it is rejected and then revived at a higher level NAIC committee, further action could extend well into 2015.

It should be noted that Oklahoma adopted a version of PBR that includes SCE. The version is even more liberal in one respect, providing for a group premium threshold of \$1 billion. Time will tell whether this provision will encourage some small insurers to re-domesticate to Oklahoma. In recent years, two large companies re-domesticated from California to other states. One even kept its administration in the original state. This seems to demonstrate that re-domestication is a viable tool.

PBR Adoption Status

So far, 18 states have adopted the new Standard Valuation Law (SVL)/PBR package, including two where legislation is on governors' desks. These 18 comprise a little over 26 percent of nationwide 2008 premiums. The required total remains 75 percent of these premiums. ACLI lobbyists seem to be moving aggressively in promoting adoption. Since the SCE amendment mentioned above may be stalled, some have questioned these aggressive efforts.

In both December and March, one prominent commissioner at the NAIC expressed support for small company concerns over PBR effort and expense. However, no effort has been made since to pressure LATF to move on the key SCE amendment.

Other ACLI Amendments

ACLI also proposed two other amendments. For those using the Stochastic Exclusion Test (SET), the passing threshold had been 4.5 percent. However, little test work

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had been completed for certain products. The proposed 6 percent threshold should provide some cushion.

Second, VM20 requires detailed procedures for computing reserve mortality, involving margins and credibility. For asset adequacy tests, computed reserves are for testing only. Many have felt that VM20 mortality procedures for these test reserves are too onerous. This amendment proposal clarifies that, for asset adequacy purposes, the degree of VM20 precision is not required.

VM22 and PBR for Non-Variable Annuities

A Kansas field test is being made for one type of annuities, those with guaranteed minimum benefits. The eventual PBR objective would be for reserve options with election probabilities, rather than current 100 percent election rates under CARVM. Spokesmen for the Annuity group have stated several times that they intend to take small company concerns about PBR simplicity into account.

Actuarial Opinion Model Regulation

Key changes will be made to the process for communicating actuarial findings. As a minimum, a summary actuarial report must be presented to the board of directors and discussed with them. If an outside consultant prepares the report, he won't necessarily have to appear before the board in January and February peak workload months. The entire Actuarial Memorandum, containing formulas and tables, won't have to be read by the board.

New Statutory Mortality Table, 2014 VBT

This new table is almost complete, but some work remains on the question of mortality rates at very high ages. These have a key impact on reserve levels, due to their relations with still-improving younger age mortality. Related reserve problems with 2008 VBT reserve levels should not be repeated.

The VBT plus margins will result in the 2014 CSO. Hopefully, these will be completed in the summer of 2015.

Work on separate mortality tables for pre-need and guaranteed and simplified issue is in process, but stalled by the margin project for the 2014 CSO.

Experience Reporting and Data Collection—Expenses

New York has long desired to receive industry splits of expenses not included in pricing or current reserve calculations, due to lack of critical company mass or other reasons. Therefore, they have gone ahead with emphasis on expense compilation and reporting, including required splits not found in Annual Statements. The ACLI has objected to this type of data reporting, partly on grounds that data on policyholder behavior should be a higher priority.

Statutory Accounting

So far, there have been no 2014 proposals that would endanger current statutory accounting.

Other Amendments and Updates Adopted or Discussed by LATF

It was agreed that the Valuation Manual's governance section could be amended at LATF conference calls, not just the three NAIC on-site meetings.

Updated asset spreads for VM20 to reflect year-end 2013 data were adopted.

A due premium proposal from the American Academy of Actuaries had been discussed for some time. The amendment that required inclusion in cash flows was finally adopted.

A proposed guideline for indexed universal life (IUL) was discussed. The ACLI will work further with some regulators who had comments and concerns.

Summary

Even with the new SVL/PBR package adopted by the NAIC in December 2012, there seems no end to complexities that must be faced by small insurers. The author recommends that small insurers continue to stay alert and stay informed. ●



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Qualification Considerations for U.S. Actuaries

By Mark Rowley and Brad Shepherd

As we all know, every U.S. actuary has a responsibility to determine whether or not they are qualified for a particular assignment. This requires a thorough understanding of the U.S. Qualification Standards (QS) which are promulgated by the American Academy of Actuaries (AAA). We suspect that much of this article will be a refresher for you, and we hope that is beneficial. In addition, we hope this article will provide some insight on various aspects of the QS. We have included five example situations to encourage you to think about how the qualification standards would apply to some practical, everyday situations.

Background

In order to understand the context of the QS, we first should talk about the Code of Professional Conduct that has been adopted by all five U.S.-based actuarial organizations.

- The Code of Professional Conduct requires actuaries to adhere “to the high standards of conduct, practice, and qualifications of the actuarial profession, thereby supporting the actuarial profession in fulfilling its responsibility to the public.”
- Precept 1 of the code says “An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession’s responsibility to the public and to uphold the reputation of the actuarial profession.”
- Precept 2 of the code says “An Actuary shall perform Actuarial Services only when the Actuary is qualified to do so on the basis of basic and continuing education and experience, and only when the Actuary satisfies applicable qualification standards.”

The QS are issued by the AAA, but by virtue of the Code of Professional Conduct they apply to members of all five U.S.-based actuarial organizations.

Throughout your career, you may have seen examples of poor actuarial work. It is possible that this work was in violation of the Code of Professional Conduct. In these situations we have an obligation under Precept 13 (http://www.actuary.org/files/code_of_conduct.8_1.pdf) to take certain steps to remedy the situation.

It is important to remember that poor quality actuarial work adversely impacts at least the:

- Employer or client of the actuary
- General public
- Insurance company policyholders
- Actuarial profession
- Individual actuary.

Poor quality actuarial work can happen for various reasons. A challenging target date can tempt the actuary to cut corners. A tight budget can make it difficult to hire the consultant you need to provide necessary peer review. When actuaries have to take a position unpopular with their management they might be concerned about their job security.

The goal of the Code of Professional Conduct and the QS is the same—to help actuaries provide high-quality work

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that will serve the public well. The Code of Professional Conduct sets high standards for how actuaries do their work.

QS

The next part of this article refers to various sections of the QS, which can be read in their entirety at http://www.actuary.org/files/qualification_standards.pdf.

Section 2 of the QS defines general qualification standards, both for basic education and experience and continuing education. To talk about the QS a few terms need to be defined:

- Statement of Actuarial Opinion (SAO) is “an opinion expressed by the actuary in the course of performing Actuarial Services and intended by that actuary to be relied upon by the person or organization to which the opinion is addressed.”
- “Actuarial Services” are “professional services provided to a Principal (client or employer) by an individual acting in the capacity of an actuary. Such services include the rendering of advice, recommendations, findings, or opinions based upon actuarial considerations.”

There are various key words in these definitions including *opinion, intended, relied, acting, capacity* and *considerations*. If a qualified actuary does work where an opinion is expressed that was intended to be relied upon while acting in the capacity of an actuary, and the opinion took into account actuarial considerations, then it is within the scope of the QS. An Actuarial Opinion can be oral or written.

Section 3 of the QS defines specific qualification standards. These apply to SAOs listed in Section 3, which include the NAIC actuarial opinions for life, health and property/casualty.

Section 2.1 of the QS discusses additional requirements to issue an SAO when a specialty track is offered by the Society of Actuaries (SOA) or an area of practice is covered by an exam of the Casualty Actuarial Society (CAS) or American Society of Pension Professionals & Actuaries (ASPPA). It is common for small company actuaries to be asked by their employer to work in various practice areas where a specialty track applies within the SOA syllabus. It is often onerous for small company actuaries to meet the requirements of Section 2.1. It can also be onerous for other actuaries. The section requires having completed the vari-

ous specialty tracks or being able to document responsible actuarial experience in each practice area.

The SOA’s current practice areas are: *Corporate Finance and ERM, Quantitative Finance and Investment, Individual Life and Annuities, Retirement Benefits, Group and Health, and General Insurance*.

Let’s go through a few examples.

1. **An actuary obtained the FSA under the Individual Life and Annuities track. Can the actuary issue an SAO that includes investment advice?** One answer is no, because the actuary didn’t take the Quantitative Finance and Investment track. Another answer is yes because there was investment material in the track that the actuary completed. A third answer is no, if the kind of investment advice the actuary is offering is beyond what was learned in the track. Perhaps the advice the actuary needs to give is related to option pricing and hedging strategy. The other critical issue is whether, regardless of the rules in the qualification standards, the actuary can look in the mirror and confidently say that he or she can competently do this. The great majority of actuaries are able to exercise professional judgment and know when they are in over their heads. The ability to exercise professional judgment is crucial to doing quality work and satisfying the code of conduct.
2. **An example very similar to this is when an actuary issues an SAO that includes enterprise risk management (ERM) advice.** We will let the reader fill in the details.
3. **The SOA developed a new specialty track in an area where the actuary is currently qualified—does the actuary need to complete the new specialty track?** The answer is no—the basic education and experience requirements need only be satisfied once.
4. **The actuary is considering taking a new position with a group health company that needs an appointed actuary.** The actuary is currently the appointed actuary for a life company. Must the actuary meet the Specific Qualification Standards for issuing a SAO for signing a health annual statement? The answer is yes. Section 4.1 of the QS discusses what is needed when an actuary changes a practice area.

5. **A small company actuary “dabbles in health.”** The actuary’s company has a small health block. The actuary did not take the Group and Health track and hasn’t done much health continuing education. Can the actuary issue SAOs for this block? There is minimal coverage of health insurance on other SOA tracks. Can the actuary look in the mirror and confidently say he or she can competently do the work? Small companies may not have the budget to hire a health consulting actuary who is clearly qualified. Is it OK for the actuary to issue the SAO because the reserve is so small? The qualification standards don’t address the issue of materiality. Possible options to address this include getting advice from a qualified actuary in that area. It is also worthwhile to explore options for having a qualified actuary review your work.

Parting Thoughts

A possible interpretation of the QS is that they are a competency test rather than a confidence test. If actuaries are competent, but not confident, they will do the right thing by bringing in someone else to help. The danger, and possible Code of Professional Conduct violation, is if they are incompetent, but confident, because they could do poor quality actuarial work.

Actuaries are quite safe from being challenged on their qualifications if they make a reasonable attempt at complying with the standards. Moreover, they enjoy by far the best protection from being challenged if they use good professional judgment and do quality work. They need the ability to look in the mirror and honestly assess whether they can do the work competently.

Actuaries often get asked to do work where they are not qualified. Our advice in that situation is to consider the following:

- Review Precepts 1 and 2 of the Code of Professional Conduct, which will lead you to not do the work on your own.
- Get consulting help.
- Present your dilemma to decision-makers.
- Ask other actuaries for advice. Build a network of other actuaries through the SOA or individual sections. Many small company actuaries have done this successfully through the Smaller Insurance Company Section.

If there is a question about qualification standards it is best to reach out to the Academy’s Committee on Qualifications: <http://www.actuary.org/content/qualification-standards-1>.

We hope this article has been useful for you. We invite your comments on it. Simply contact any of the authors. ●

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